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Romanian Bankruptcy Assessment

INITAL DISCUSSION PAPER

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Introduction

Enormous changes are taking place in Romania's economy As with any fundamental change in the economy, commercial enterprises will be affected Some will succeed, others will fail In the wake of privatization, it is probable that there will be an increase in the number of commercial insolvencies How these insolvencies are handled is of great concern to everyone participating in the arena of commerce, both domestically and abroad

Importance of a Working Insolvency System

A transparent and certain bankruptcy system is a critical necessary component of a market economy—

- to accomplish an efficient fair and equitable reorganization where a business enterprise can be saved
- to provide an orderly means of exit when it can not,
- to provide a method to recycle assets back into productive use
- to promote the flow of credit by protecting creditors' rights, and
- to encourage the use of credit to finance economic growth

Legislative Status

- Romanian Bankruptcy Law Law 64/1995
- Law 64/1995 has been modified by E O 58/1997
- E O will soon be considered by Parliament
- Most judges and many professionals believe that E O 58 contains certain provisions that impede effective functioning of the bankruptcy system
- A dialogue between judges, professionals (those who use the law) and the Ministry of Justice, members of Parliament (those who write the law) would greatly enhance the effectiveness and clarity of future bankruptcy legislation

With this discussion we hope to achieve

- An increased awareness of the workings and status of the bankruptcy system,
- An exchange of ideas and information so that those who are affected by the law can be heard by lawmakers and judges,
- An exchange of ideas and information so that lawmakers and judges will have a better sense of current realities with regard to commercial law and insolvency issues

Romanian Bankruptcy Law Attributes

- **The law has a progressive orientation**
  A There is a business rescue culture/reorganization provision
  B There is a recognition that honest business failure is not a crime
  C The law represents a modern enlightened view

- **Judges are interested in solving problems**
  Visits with judges in Cluj, Brasov, Constanta, Iasi, Craiova, Timisoara, Slatina Braila

Issues/Weaknesses

A Law overburdens syndic judges with non-judicial managerial responsibilities

The syndic judges in Romania have an inordinate responsibility with regard to the actual operation of debtor s business No other known insolvency system burdens a judge with these administrative tasks Some of the responsibilities include

- Applying seals Art 10(a),
- Taking inventory Art 10(b),
- Receiving the payments Art 10(i),
- Examining the activity of the debtor Art 10(h),
- Turning the assets into cash Art 10(j),
- Managing the debtor's business activity Art 10(e),
- Investigating and issuing a report on the cause and circumstances of the bankruptcy and information on individuals responsible Art 35

With the high degree of syndic judge involvement in the business workings of debtor enterprises there is a strong possibility that the judges will become overwhelmed upon either a) the initiation of a large complex case, b) an increase in the volume of ordinary bankruptcy cases For example one large reorganization may consume well over half of the syndic judge's time, as is the case with Banca Dacia Felix in Cluj In the wake of privatization, where it is expected that a large number of enterprises will be subject to business failure, it is highly likely that the syndic judges will be overwhelmed

B Judges do not want to be company managers and not trained to be crisis managers

Syndic judges in Romania are typically commercial law tribunal judges appointed to bankruptcy cases in addition to their existing commercial caseloads As such, they are not specialized in bankruptcy The judges possess legal training, not business training Almost all lack training in areas vital to the running of a commercial enterprise such as accounting, economics, finance, and management A majority have expressed an unwillingness to give up traditional judicial practice to perform the syndic judge function Most believe that this role is better left to business professionals

C Inability to appoint qualified administrative receivers

1 Impossibly high creditor vote required for appointment

The law currently makes it virtually impossible for a syndic judge to appoint an administrative receiver (trustee-like business professional) to administer the debtor business making the sndic judge the *de facto* chief executive Originally, Law 64 required an affirmative vote of over 50% of creditor debt to appoint an administrator The new amendment E O 58 now requires that creditors holding 75% of the outstanding debt to affirmatively vote by a 50% margin to obtain the appointment of an administrator (Art 17) This makes it highly unlikely that an administrator will be appointed given that most creditors are generally passive and tend not to participate in the bankruptcy process or tend to view an administrator as a drain on assets otherwise available for debt repayment

An alternative would be to allow the syndic judge to appoint an administrator at his/her discretion but to provide creditors with notice of the appointment and an opportunity to object for good cause The tribunal court would rule on the merits of such objection

2 Inadequate funding for administrators

At present, the judges are unable to access funds necessary to hire qualified administrative receivers and liquidators, or to otherwise administer the case One proposal advanced by the Romanian Bankruptcy Institute is to raise funds for such administration via a general business risk tax An alternative would be to provide that all expenses of administration (including the cost of hiring an administrator or liquidator) receive the highest priority of distribution of the assets of the debtor This would ensure that funds would be available to hire professionals of adequate caliber and experience commensuiate with the complexity of the case

3 Lack of qualified cost-effective administrators willing to accept appointment

At present, judges cannot find qualified professionals to accept appointment as administrators or liquidators due to the currently very low pay allocated for such appointment This will very likely change if funds are made available for fees to attract qualified professionals As business professionals discover bankruptcy case engagements to be lucrative and cost beneficial, more will seek training and skills to enable them to accept such engagements At present, many professionals have declined to accept bankruptcy engagements as they are known to provide little compensation relative to other commercial practice areas

D Syndic judges are not specialized, they are typically commercial tribunal judges

Since almost all syndic judges are also tribunal judges who carry an ordinary civil or commercial caseload, only part of their responsibility covers the highly technical area of bankruptcy Judges have no opportunity to build upon experience in dealing with the specialized subject matter on a day to day basis

E Potential conflict of interest exists

Because the syndic judge is also a tribunal judge, there is also a potential conflict of interest when the syndic judge s action is challenged Objections to a syndic judge s action are brought before the very tribunal where the syndic judge normally sits for resolution by the syndic judge's colleagues There is the sense that opposing party may feel that the tribunal may rule in favor of their colleague the syndic judge

F Filing of recovery actions by syndic judge requires payment of a stamp tax

The syndic judge is treated as an ordinary commercial litigant when filing actions for the annulment of fraudulent transactions or conveyances and recoveries of property The judges do not have funds designated or available to pay the filing fee (stamp tax) The judges should be able to either a) use funds form the debtors assets, b) use funds from a designated fund available for such purpose, or c) be exempt by law for such stamp tax when initiating such an action

G Law encourages creditor petitions as a device for resolving ordinary commercial claims

Currently 95% of all bankruptcy case are initiated by creditor petitions Many of these cases are single-creditor debt collection actions that do not involve a general cessation of payments by the debtor enterprise The law presently encourages the use of the bankruptcy system as a primary form of debt collection because the bankruptcy case filing fee (100,000 lei, approximately $10 USD) is far less costly than a the ordinary commercial case initiation fee (which is a stamp tax of 10% of the amount in dispute) The economic incentive to initiate a bankruptcy case in these instances should be removed

H Law provides little or no sanction power over recalcitrant/disobedient debtors

At present there is little power available to the syndic judge to compel a debtor to provide information required under the law Since most cases are creditor initiated against the will of the debtor, threats of case dismissal have little or no effect Expanded powers to compel recalcitrant parties to comply with provisions of the bankruptcy law are necessary

I Lack of well-developed procedures and norms

Judges have voiced a concern that there is little guidance on how to apply the bankruptcy laws in areas where the law does not speak or instances where the law is ambiguous Unlike the U S and the U K , in a civil law system there is no reliance on case law to illuminate how other courts may have handled the issue previously Some judges have requested a code of procedure to be prepared by the Ministry of Justice, while others hope to consult a bank of published articles on bankruptcy topics However, these solutions will probably not cure the judge's perceived need for clear rules and procedures covering all areas The bankruptcy law covers a broad range of commercial activity, and a vast variety of widely-differing types of businesses can pass through the bankruptcy system No code or procedural rule book will cover all areas of issue to the degree that the judges have been accustomed in the Romanian civil code system Additional training in the application of the law with an emphasis on flexibility and problem solving is needed with the assistance of foreign advisors from countries with well-developed commercial insolvency systems

J Key reorganization tools under law 64 are eliminated in E O 58

Key provisions of Law 64 are now made wholly inapplicable to reorganization cases by amendments contained in E O 58 Specifically, those provisions allowing for contract rejection and conveyance recovery are now applicable only to liquidation cases E O 58 simply carves out all provisions contained in Section III of Law 64 (Arts 36 - 54) making them ineligible for use in reorganizations (See Art 38) At present, a reorganization debtor cannot have the benefit of the assets recovered from fraud or transfers made for less than actual value (Arts 39 and 40) Nor can burdensome contracts be rejected (Art 46) These tools are indispensable to a debtor s ability to reorganize and many times they formulate the very basis for the viability of a reorganization plan These provisions were designed to aid reorganizations and the law should be changed to make them fully applicable

K Persons with standing to recover transfers are limited only to Liquidators

At present under E O 58, only the liquidator has clear standing to initiate recovery actions under Art 44 Other persons should be allowed to bring recovery actions including the syndic judge, administrator, liquidator, and the creditors committee

L Interest on unsecured claims

At present, the law provides that interest and penalties on unsecured claims cease to accrue at the point of claim registration potentially allowing for different points in time for the cessation of interest on different claims depending solely on when the particular claim was registered (Art 87) The law should state that interest ceases to accrue upon the opening of the proceeding In addition, the law should make clear under what circumstances interest on secured claims accrues or does not accrue It is presently ambiguous whether interest and penalties continue to accrue on the secured portion of a claim in excess of collateral value This could lead to a potentially unlimited unsecured claim for interest and penalties generated from the secured portion of the claim

M Distribution priorities

The distribution priorities in a bankruptcy case (Art 107) should be revisited to ensure that the goals and purposes of the bankruptcy are being effectuated

- At present, under E O 58 it is unclear what place secured claims will take or whether secured creditor s rights are protected vis-a-vis other claimants

- The present distribution scheme does not make clear how government budgetary claims will be treated (See Parag "N" infra)

- Expenses related to the administration of the case are split among four different categories receiving first, second, seventh and eighth priorities These administrative expenses should receive a very high or highest priority

- The present law fails to grant priority status for debts arising during the reorganization period or for credit extended to the debtor for purposes of the reorganization The law therefore discourages others from doing business with a reorganization debtor thereby further advancing its decline

- The bankruptcy distribution priority scheme under Law 64/1995 and E O 58/1997 differs significantly with that of the voluntary liquidation distribution scheme under Law 31/1990 and Emergency Ordinance 10/1997 (approved by Law 151/1997) under Romania's general corporation law Both should be reexamined for consistency with sound policy and with each other to eliminate differing distribution schemes as a reason for forum shopping

N State budgetary enforcement power potentially supersedes preexisting secured interests

At present, the law allows inconsistent ambiguous treatment of budgetary debts E O 58 adds that state budgetary debts are to be treated in compliance with Ordinance 11/1996 Ordinance 11 allows the government to quickly seize assets seemingly without distinction as to whether they are subject to a prior-in-time security interest It is unclear to many syndic judges whether Art 31 of Law 64, which suspends all prior judicial or extra judicial legal actions would operate to prevent an Ordinance 11 asset seizure by the government A quick seizure of assets irrespective of the bankruptcy proceeding would have the potential to frustrate the entire reorganization If such a seizure ignores the existence of a pre-existing security interest, secured creditor rights would be irreparably compromised This situation if uncorrected could operate to seriously diminish the development and growth of commercial lending in Romania

Comparison of Law 64 and Law 31

Legal Framework for Liquidation Two Laws

Administrative Liquidation

- Law 31/1990 (November 17, 1990)(assumed solvent, did not list priorities)
- Emergency Ordinance 10/1997(April 19, 1997)(approved by Law 151/1997)(Contains provisions for companies with state owned capital)

Judicial Liquidation (Bankruptcy)

- Law 64/1995 (June 29, 1995)
- Emergency Ordinance 58/1997 (October 3, 1997)

Administrative/ Law 31	Judicial/ Law 64
Faster- Little or no court involvement	Slower-Syndic and Tribunal Judges involved at most stages, noticing procedures and requirements take time, Creditor committee involvement
Liquidator is independent- can sue or be sued	Judge controls liquidator Extra layer of management
Liquidation is the only option	Liquidation or reorganization- Debtor must declare intent Also Liquidation plan possible
Liquidator mandatory	Administrator or Liquidator
Does not impede a Law 64 petition Law 31/Art 183	Can override Law 31 Liquidation at any time Law 64/Art 31
Does not suspend legal action against company	Suspends legal action against company Law 64/Art 31
Interest and penalties continue to accrue unaffected	Interest and penalties cease to accrue on unsecured claims post-petition, On secured claims they accrue only up to value of security
No provisions for avoidance actions and annulment powers	Provides for preference and transaction annulment and annulment of executory contracts Law 64/Arts 38-44, 46
Liquidation priorities differ (see chart)	Liquidation priorities differ (see chart)

	ADMINISTRATIVE	JUDICIAL
LAW	LAW 31/1990 MODIFIED BY EMERGENCY ORDINANCE 10/1997, APPROVED BY LAW 151/1997	LAW 64/1995 MODIFIED BY EMERGENCY ORDINANCE 58/1997
STATE BUDGET	SEE PRIORITY #4	ACCORDING TO LAW 72/1996 - GOV ORD 11/1996 AND LAW 108/1996 ART 106
SECURED CREDITORS	SEE PRIORITY #3	PAID FROM SALE OF SECURED ASSETS ART 104
1	EXPENSES OF SALE / COMPLETING LIQUIDATION PROCEDURE ART 7 (3) (a)	DUTIES STAMPS EXECUTION EXPENSES ART 107 (1)
2	OVERDUE WAGES ART 7 (3) (b)	REMUNERATION OF SPECIALISTS ADMINISTRATORS/LIQUIDATORS (ART 9 17 18[1]) ART 107 (2)
3	SECURED CREDITORS MOVABLE/IMMOVABLE ART 7 (3) (c)	BANK CREDITS WITH INTEREST AND EXPENSES ART 107 (3)
4	STATE RECEIVABLES, TAXES CHARGES OTHER FISCAL OBLIGATIONS, STATE BUDGET SPECIAL FUNDS ART 7 (3) (d)	INDIVIDUAL DEBTOR AND FAMILY SUPPORT ART 107 (4)
5	STATE GRANTED LOANS ART 7 (3) (e)	EMPLOYMENT CONTRACTS (PRIOR 6 MONTHS) ART 107 (5)
6	UNSECURED CREDITORS ART 7 (3) (f)	AMOUNTS DUE TO THIRD PARTIES FOR FOOD AND RENT (PRIOR 6 MONTHS) ART 107 (6)
7	SHAREHOLDERS / ASSOCIATES ART 7 (3) (g)	PROCEDURE EXPENSES NECESSARY TO PRESERVE ADMINISTRATE DEBTORS ASSETS ART 107 (7)
8	LATE CREDITORS/CLAIMS ART 7 (3) (h)	DEBTS FROM CONTINUATION OF ACTIVITY (EXTENSION BY ART 69) ART 107 (8)
9		OTHER UNSECURED RECEIVABLES ART 107 (9)
10		FRAUDULENT/INADEQUATE CONDUCT(UNDER ART 96) ART 109
11		LATE CREDITORS/CLAIMS ART 110
12		SHAREHOLDERS ART 115